

STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE  
45 Fremont Street, 21<sup>st</sup> Floor  
San Francisco, California 94105

**SUBCHAPTER 4.11 Residential Property Insurance, Acknowledgment Requirements,  
Records Maintenance, Retention, Report**

**INITIAL STATEMENT OF REASONS**

**CDI File No. RH05044911**

**Date: April 25, 2005**

California Insurance Commissioner John Garamendi will hold a public hearing to consider regulations governing the rates, rating plans, rating systems and underwriting rules of California residential property (homeowners) insurers, specifically considering the adoption of Title 10, California Code of Regulations, Chapter 5, Subchapter 4.11, Article 1, Section 2371, *et seq.* The proposed regulation is entitled: ***SUBCHAPTER 4.11 Residential Property Insurance, Acknowledgment Requirements, Records Maintenance, Retention, Report***

**STATEMENT OF SPECIFIC PURPOSE**

As set forth directly below, this regulation has three main purposes,

Acknowledgement Requirements: The purpose of this regulation is to define, clarify and make specific requirements regarding information to be shared by the insurer with the insured or potential insured about the terms of any contract of residential property insurance sold in California in order to prevent unfair or deceptive acts or practices in the sale of policies of residential property insurance and to avoid unfair methods of competition in the insurance marketplace pursuant to Cal. Ins. Code §§790.02, 790.03, 790.10, and 12826

Records Retention: The purpose of this regulation is to clarify and make specific the standards for the maintenance and retention and reporting requirements of records and data related to rates, rating plans, rating systems and underwriting rules such that the Commissioner may determine that the rates, rating plans, rating systems and underwriting rules used by insurers do not result in rates that are excessive, inadequate, unfairly discriminatory or otherwise in violation of the law pursuant to Cal. Ins. Code §§1857, 1861.05 and 12926.

Rate Regulation: The purpose of this regulation is to clarify and make specific the standards for the calculation of insurance rates pursuant to rating plans, rating systems and underwriting rules such that the rating plans, rating systems and underwriting rules used by insurers do not result in rates that are excessive, inadequate, unfairly discriminatory or otherwise in violation of the law pursuant to Cal. Ins. Code §§1857, 1861.05 and 12926.

The stated purpose of Proposition 103 "is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all

Californians." The purpose of this regulation is to facilitate the Commissioner in the performance of his duties as required by law.

## **STATEMENT OF SPECIFIC STATUTORY AUTHORITY**

### **Unfair Practices Act**

The stated purpose of Cal. Ins. Code §§790 *et seq.*, entitle *Unfair Practices*, is “to regulate trade practices in the business of insurance . . . by defining, or providing for the determination of, all such practices in this State which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined.” In promulgating this regulation the Commissioner is “providing for the determination” of acts or practiced he believes to be unfair within the meaning of the Unfair Practices Act. It is clear that the act gives the Commissioner express authority to define and make specific those acts or practices he determines “pursuant to the act” to be “unfair.” Cal. Ins. Code §790.10 provides the Commissioner with specific, express, statutory authority to issue rules that identify and define specific unfair practices.

### **Records and Examinations**

The stated purpose of Cal. Ins. Code §1857 is to require every insurer in California to “maintain reasonable records, of the type and kind reasonably adapted to its method of operation . . . used by it in connection with the rates, rating plans, rating systems, underwriting rules . . . used by it so that those records will be available at all reasonable times to enable the commissioner to determine whether every rate, rating plan, and rating system made or used by it, complies with the . . .” the law. Cal. Ins. Code §1857(i) provides the Commissioner with specific, express, statutory authority to issue rules that identify, define and make specific those records that must be maintained by insurers doing business in this state.

### **Insurer Reports**

Cal. Ins. Code §1857.9 provides the Commissioner may require property and casualty insurers to issue reports containing data specified by the Commissioner. Cal. Ins. Code § 1857.9(h) provides the Commissioner with specific, express, statutory authority to issue rules that identify, define and make specific what information is to be contained in the reports and to require insurers to issue reports per his instructions as to form, data and information required to be reported.

### **Verification of Data**

Cal. Ins. Code §1861.05 provides that, “No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In rating and underwriting policies of insurance insurers must use data that is true and correct. Rates and premiums based on incorrect or faulty data are arbitrary. Rates and premiums resulting from calculations made using faulty data are excessive, inadequate or unfairly discriminatory. Cal. Ins. Code § 1861.05 provides the Commission with broad authority to issues rules of general application in order to regulate rates. Requiring insurers to take reasonable steps to verify the

accuracy of data is well within this authority.

Arbitrary rating and underwriting factors, in cases where “underwriting” impacts rates, result in rates that are excessive, inadequate or unfairly discriminatory, in contravention of Proposition 103. Where factors used to price an insurance product are not related to the future costs associated with the risk, the factors are arbitrary, producing arbitrary rates. The verification requirements are designed to assure that the rates calculated by application of data used in rating plans, rating systems and underwriting rules, produce rates that meet all statutory requirements.

Further, in *State Farm Mutual Automobile Insurance Company v. Garamendi* (32 Cal. 4th 1029; 88 P.3d 71; 12 Cal. Rptr. 3d 343; 2004) the California Supreme Court made clear that the Commissioner’s authority under Proposition 103 is extremely broad. The court noted that the stated purpose of Proposition 103 is “to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians.” (Historical and Statutory Notes, 42A West’s Ann. Ins. Code (1993 ed.) foll. § 1861.01, p. 649.)” The Supreme Court also made it clear that Proposition 103 is “not only about rates and rate regulation; it also concerns other factors that may impermissibly affect the availability of insurance.”

### **Unfair Discrimination**

The Commissioner has reason to believe that some residential property rating and underwriting rules currently in use in California are having an unfairly discriminatory impact on low-income and fixed income policyholders. The Commissioner is charged with an affirmative duty to prevent unfair discrimination in insurance rates and availability. The reporting requirements contained in the regulation are designed to allow the Commissioner to ascertain whether specific rating and underwriting rules are having an unfair impact on any specific group of California insurance consumers.

### **PROPOSED REGULATION BY SUBSECTION**

The following are statements of specific purpose and effect of each subsection of the proposed regulation including the rationale for the determination that each subdivision is reasonably necessary to carry out the purpose for which it is proposed. The proposed regulation is designed to address residential property insurance availability and unfairly discriminatory rating and underwriting in California.

### **Proposed California Code of Regulations section 2371.1 - Adopt**

The proposed subsection provides the purposes of the regulation and the problems the regulation is designed to address. The purpose of the subsection is to make clear and specific what the regulation is intended to address and accomplish. The language is therefore reasonably necessary to make clear to impacted entities and the public the reasons for the Commissioner’s action.

### **Proposed California Code of Regulations section 2371.2 – Adopt**

The proposed section specifies the applicability of the regulation. The purpose is to make clear to the public and impacted entities what lines of insurance are the subject of the regulation. The language is reasonably necessary to effectuate that purpose.

### **Proposed California Code of Regulations section 2371.3 – Adopt**

The proposed subsection sets forth definitions for the terms used substantively throughout the regulation. The purpose is to clarify and make specific the meaning of various terms used in the substantive portions of the regulation throughout the regulation. The language is reasonably necessary to effectuate that purpose.

### **Proposed California Code of Regulations section 2371.4 - Adopt**

This proposed subsection sets forth certain requirements relating to information that must be communicated to potential insureds at the point of sale. The Commissioner believes that well informed consumers make better consumers. The Commissioner also believes that insurers should be responsible for making sure the policyholder is informed of all pertinent information relating to coverage and claims and policyholders should be made aware of the consequences of their actions before taking such actions. The purpose of the subsection to see to it insurance consumers are informed about the products they purchase. This section also contains a reporting requirement. This reporting requirement is designed to allow the Commissioner to study the impact of various rating and underwriting rules used by insurers in California. The language is therefore reasonably necessary to make clear to impacted entities and the public the requirements as set forth.

### **Proposed California Code of Regulations section 2371.5 - Adopt**

This proposed subsection goes directly to rates. The subsection sets forth the requirement that the various factors used to rate policies, in order to be reasonable, must bear a relationship to future risk. The purpose is to make clear to impacted entities and the public that arbitrary rating factors produce arbitrary rates which are by definition unfairly discriminatory. The language is necessary to make clear the standards to be applied in California and is reasonably necessary to effectuate that purpose.

### **Proposed California Code of Regulations section 2371.6 - Adopt**

This proposed subsection goes directly to rates. The regulation is necessary because information used in rating policies must be accurate. The Commissioner believes a significant amount of information being relied by insurers to rate policies may be erroneous. The subsection requires insurers to take reasonable efforts to verify the soundness of information used to rate policies. The language is necessary to make clear the standards to be applied in California and is reasonably necessary to effectuate that purpose.

## **Proposed California Code of Regulations section 2371.7 - Adopt**

This proposed subsection requires insurers to keep specific records such that the Commissioner may determine that the rates and underwriting rules used by insurers are in compliance with the law. This subsection is necessary because unless there are records of certain events and actions taken by insurers the Commissioner has no way to determine whether insurers are in compliance. The language is necessary to make clear the standards to be applied in California and is reasonably necessary to effectuate that purpose.

### **IDENTIFICATION OF STUDIES AND REPORTS**

The Commissioner did not rely upon any specific technical, theoretical and/or empirical study, report or similar document in drafting the proposed regulation. However, much information is now available that relates directly to problems in the residential property insurance market. To the extent that any specific technical, theoretical and/or empirical study, report or similar document is reviewed or relied upon during the rulemaking process, such study or report or similar document will be made part of the rulemaking file.

### **SPECIFIC TECHNOLOGIES OR EQUIPMENT**

Adoption of the proposed regulation would not mandate the use of specific technologies or equipment.

### **CONSIDERATION OF ALTERNATIVES**

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective as and less burdensome to affected private persons than the proposed action. The Commissioner, however, invites public comment on alternatives to the regulation.

Performance standards were considered. The objective identified was fairness in residential property rating. However, one of the reasons performance standards were rejected was the Commissioner does not, at the present time, have the data needed to determine the standards. The regulation will allow further study that may lead to performance standards in the future.

The proposed regulation is one part of an ongoing process designed to address several ongoing problems in the residential property insurance market. Other alternatives include and have included communication with individual insurers and the industry as a whole, other regulations and legislation. The ongoing program is known as “The Homeowners Bill of Rights.”

Having focused on the problems outlined in this document for over two years the Commissioner believes the proposed regulation represents the best and most viable alternative at the present

time.

Finally, the Commissioner continues to study alternatives.

**IMPACT ON SMALL BUSINESS**

The Commissioner has determined that the proposed regulations do not affect small businesses.

Date: April 27, 2005

JOHN GARAMENDI  
Insurance Commissioner

By: \_\_\_\_\_  
Donald P. Hilla  
Senior Staff Counsel